

Message Text

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E.O. 11652: N/A

TAGS: EGEN, CO

SUBJECT: INFLATION AND THE PESO

SUMMARY:

THE GOC IS FACING A CLASSIC DILEMMA. GIVEN BOOMING COFFEE EARNINGS AND SAGGING NON-COFFEE EARNINGS, WHAT IS THE PROPER PRICE FOR THE PESO? THE COSTS OF WRONG DECISION CAN BE INFLATION ON THE ONE HAND OR SLOWER GROWTH ON THE OTHER, AND THE TOOLS WHICH MIGHT BE USED TO GET THE BEST OF BOTH WORLDS WOULD REQUIRE A STEP BACKWARDS IN POLICY AND MAY BE PERSONALLY DIFFICULT FOR PRESIDENT LOPEZ OR FINANCE MINISTER BOTERO TO ADOPT. IN THE MEANTIME THE PRESIDENT AND HIS FINANCE MINISTER ARE BEING CRITICIZED BITTERLY BY BUSINESSMEN WHO ARE CALLING FOR A RETURN TO THE GOOD OLD DAYS, WHICH WERE NOT VERY GOOD SINCE THE ECONOMY IS STILL SUFFERING FROM PREVIOUS MISMANGEMENT. END SUMMARY.

1. THE CONSUMER PRICE INDEX SHOWED ANOTHER LARGE INCREASE IN AUGUST, 1.4 PERCENT FOR WORKERS AND 1.5 PERCENT FOR EMPLOYEES, REACHING ALMOST 18 PERCENT SO FAR

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FOR THE YEAR. THE INCREASE IN AUGUST WAS BELOW THE

2.6 PERCENT CHANGE IN JULY, BUT IF INFLATION CONTINUES AT THIS RATE THE ANNUAL CPI CHANGE WILL BE ABOUT 24 PERCENT. THE ADMINISTRATION HAS APPLIED MOST OF THE MONETARY AND FISCAL TTOLS AT ITS DISPOSAL AND HAS SUCCEEDED IN HOLDING MONETARY GROWTH TO 9 PERCENT FOR THE YEAR, BUT THE EFFECT OF THE HIGHEST COFFEE PRICES IN HISTORY HAS SIMPLY BEEN TOO STRONG.

2. THE APPLICATION OF MONETARY RESTRICTIONS AND IMPORT LIBERALIZATION HAVE CAUSED SOME PROBLEMS OF ADJUSTMENT AND MUCH COMPLAINING AMONG BUSINESSMEN. BUSINESSMEN AND POLITICIANS IN COLOMBIAN NORMALLY MAINTAIN A HIGH LEVEL OF CRITICISM OF THE GOVERNMENT AND OF COMPLAINING BUT THEY HAVE BEEN OUTDOING THESELVES IN RECENT MONTHS. SINCE SALES ARE A RECORD LEVELS AND PROFITS ARE UP SUBSTANTIALLY, THE ADMINISTRATION BELIEVES THAT THE CRITICISM IS LARGELY POLITICALLY MOTIVATED. ON THE OTHER HAND, THE ADMINISTRATION WAS CONFIDENT OF ITS ABILITY TO REDUCE INFLATION, AND IN 1974 IMPOSED AN ENORMOUS TAX INCREASE WHICH BUSINESSMEN SUPPORTED BECAUSE IT PROMISED TO HELP IN THE BATTLE AGAINST INFLATION. SINCE INFLATION CONTINUES HIGH AND IN EXCESS OF 1975 LEVELS, IT IS NOT SURPRISING THAT THE ADMINISTRATION IS BEING CRITICIZED. FEW REALIZE, OR AT LEAST ACKNOWLEDGE, THAT INEPT MANAGEMENT OF THE PRESENT FOREIGN EXCHANGE WINDFALL ON TOP OF PREVIOUS HIGH RATES OF INFLATION COULD LEAD TO HYPER-INFLATION WITH CONSEQUENT HIGH SOCIAL AND ECONOMIC RISK. IN ANY EVENT THE CRITICS ARE CALLING FOR THE REVERSAL OF A NUMBER OF POLICIES. WHILE MOST OF THE RECOMMENDATIONS WOULD TAKE COLOMBIA BACK TO PRE-1967, IMPORT SUBSTITUTION LED GROWTH AND GREATER DEPENDENCE UPON COFFEE, SEVERAL OF THE SUGGESTIONS ARE OR HAVE BEEN STUDIED BY THE GOVERNMENT. THESE ARE THE SLOWDOWN OF DEVALUATION COMBINED WITH THE REINSTITUTION OF THE CAT, THE LEGALIZATION OF THE BLACK MARKET FOR SERVICE AND TRANSFER RECEIPTS (CAUSING THE BLACK MARKET PESO TO REVALUE) AND A PLAN WHEREBY PART OF EXPORT EARNINGS WOULD BE PAID IN A NEW DEBT INSTRUMENT.

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3. SINCE AUGUST, THE ADMINISTRATION HAS STOPPED THE PESO DEVALUATION IN AN ATTEMPT TO REDUCE THE INFLATION RATE. FROM SEPTEMBER TO SEPTEMBER DEVALUATION WAS ONLY 11 PERCENT AND SO FAR THIS YEAR IT IS ONLY 6.9 PERCENT. THE PESO IS PROBABLY UNDERVALUED IN TERMS OF THE ECONOMY AS A WHOLE, SO THAT THE SLOWDOWN IN THE DEVALUATION CAN BE JUSTIFIED. MANY BUSINESSMEN SAY THEY WANT THE SLOWDOWN TO BE PERMANENT. ACCELERATED DEVALUATION,

HOWEVER, WAS INSTITUTED IN 1974 AS A SUBSTITUTE FOR THE EXPORT TAX CERTIFICATE (CAT) SUBSIDY TO MINOR EXPORTS. WHILE EARNINGS THROUGH FROM MINOR EXPORTS, EXCLUDING SUGAR AND COTTON, WERE 6 PERCENT HIGHER THAN THE SAME PERIOD LAST YEAR AND EARNING FROM MANUFACTURED EXPORTS WERE UP BY 15 PERCENT, A LOWER RATE OF DEVALUATION COMBINED WITH 20 PERCENT INFLATION COULD SERIOUSLY REDUCE THESE EXPORTS. THE DILEMMA IS CLASSIC FOR ANY ECONOMY THAT RELIES SO HEAVILY ON AN EXPORT COMMODITY THAT FACES LOW DEMANDELASTICITY, THAT IS, A PRODUCT WHOSE PRICE FLUCTUATES BUT WHOSE SALES DO NOT. THE COLOMBIAN PESO IS UNDERVALUED IN TERMS OF THE SUPPLY AND DEMAND OF DOLLARS AND PESOS BECAUSE OF THE GLUT OF COFFEE AND SERVICE EARNED DOLLARS COMBINED WITH GOVERNMENT RESTRICTIONS ON PESO EXPANSION. HOWEVER, COLOMBIA CAN FREE ITSELF FROM EXCESS DEPENDENCE ON COFFEE ONLY BE CONTINUING THE DEVELOPMENT OF ITS NON-COFFEE EXPORTS, AND THIS REQUIRES THE PESO TO FLOAT DOWNWARD IN RELATION TO RELATIVE INFLATION RATES.

4. EITHER MULTIPLE EXCHANGE RATES OR EXPORT SUBSIDIES WOULD HELP RESOLVE THE DILEMMA BY SEGMENTING THE EXPORT SECTOR. EXPORT SUBSIDIES (CATS) HOWEVER, WERE ELIMINATED BY PRESIDENT LOPEZ BECAUSE DEVALUATION, WITH A STABLE COFFEE PRICE, IS A MORE EFFICIENT WAY TO ACHIEVE THE SAME RESULT. MOREOVER EXPORT SUBSIDIES HAVE COSTS- THEY TEND TO BE REGRESSIVE TRANSFERS, AND THEY HAVE LED TO FRAUD AND THE LOSS OF TAX REVENUES, EXACERBATING FISCAL PROBLEMS. A SLOWER DEVALUATION WOULD ALSO MAKE IT MORE DIFFICULT FOR THE GOVERNMENT TO CONTINUE WITH ITS IMPORT LIBERALIZATION POLICY. IN ADDITION, LOPEZ' CRITICS WOULD BE ABLE TO POINT TO A POLICY REVERSAL AS ALLEGED EVIDENCE THAT LOPEZ' POLICIES WERE ILL-CONCEIVED IN THE FIRST PLACE. MULTIPLY EXCHANGE RATES, (WITH A LIMITED OFFICIAL USE

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LOWER RATE FOR COFFEE) WOULD HAVE THE ADVANTAGE OF NOT REVERSING A LOPEZ POLICY, BUT WOULD BE OPPOSED BY THE POWERFUL COFFEE FEDERATION AND WOULD NOT BE CONSISTENT WITH THE ORTHODOX ECONOMIC THINKING OF THIS ADMINISTRATION.

5. IN SPITE OF ALL THIS THE GOVERNMENT MAY REINSTITUTE A LIMITED CAT ON THE VALUE ADDED OF SELECTED PRODUCTS BECAUSE SUCH A POLICY MIGHT BE SEEN AS THE LESSER OF SEVERAL EVILS. THE GOC IS PRESENTLY STUDYING THE CAT BECAUSE OUTSTANDING CATS EXPIRE IN OCTOBER. IN THE MEANTIME THE PESO HAS HARDLY BUDGED FOR A MONTH AND A HALF. WE BELIEVE THAT THE PESO IS FROZEN TO ACHIEVE AT LEAST ON MONTH WITH A LOW INFLATION RATE SO THAT INFLATIONARY EXPECTATIONS WILL BE KNOCKED BACK. THE RESUMPTION OF THE PESO DEVALUATION TO A 12-15 PERCENT

RATE COULD BEGIN SOON BECAUSE THE SEPTEMBER CPI INCREASE
SHOULD BE IN THE ONE PERCENT RANGE, LEADING TO
A YEARLY RATE OF 20-22 PERCENT.
SANCHEZ

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